

HAY/HUGGINS COMPANY, INC.

MEMBER OF THE HAY GROUP, INC

PRESENTATION BEFORE THE
POST OFFICE AND CIVIL SERVICE COMMITTEE
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

BY

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Presentation before the
Post Office and Civil Service Committee
of the United States House of Representatives

by

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Mr. Chairman:

We are honored to appear before this Committee for the third time in two years, to testify on the appropriate design of a supplemental retirement system for Federal employees who are covered by social security.

In 1983, the Congress set a deadline of December 30, 1985 for establishment of a retirement system for new and returning employees who would be covered by social security. Your committee has used that time well. You have considered all the major issues and trade-offs involved in the complex task of building a retirement system. You have examined many possible approaches to designing the new supplemental benefits. You have called on Hay/Huggins, the Congressional Research Service, and others to provide a thorough background of information and analysis. You have solicited the views and concerns of all interested parties.

In our opinion, Mr. Chairman, this thoughtful approach has proven well worth the effort. Its end product is the well designed proposal that you and Congresswoman Oakar have placed before the Committee for its consideration.

Our original testimony in 1984 covered the range of options available to you in designing the new system. Our second appearance, in April of this year, reported on our findings to date and concentrated on a more limited set of designs that were being actively considered as a basis for the new system. Today, we will review the specific features of the Ford/Oakar proposal and compare them to the two proposals incorporated in Senate Bill 1527.

The Ford/Oakar proposal was developed consistent with two guiding principles. First, the plan retains as much as possible the benefit structure of the current system. Second, where changes had to be made to accommodate the design of social security, you have used proven private sector approaches to the coordination of benefits. Through this dual approach you have succeeded in formulating a retirement system that is least disruptive to the Federal workforce and based on proven system design.

Consistent Retirement Systems

Carrying forward to the new system a basic structure similar to the current Civil Service Retirement System (CSRS), and with comparable benefit levels, is important for at least three reasons. First, a well-designed compensation system avoids providing different benefits to two similarly-situated employees. Because social security and CSRS benefits are based on greatly different approaches, it is not possible to reproduce CSRS benefits exactly in the new system. But you can ensure that the average employee will receive the same benefits under both systems.

Second, the extension of social security coverage necessitated the development of a new retirement system. Extending coverage was not then, and is not now, a mandate for sweeping changes in the basic purpose and design of the CSRS. Modifications to CSRS, if needed, should be made as a result of consideration of appropriate benefits for all federal employees. They should not be enacted through the back door, by reducing total benefits in the new system, potentially leading to cuts in the current system to conform with the new. The new system should sustain the basic design choices of the current system as far as possible.

Finally, Hay's study of total compensation in the Federal government and the private sector demonstrated clearly that retirement is the only major element of Federal compensation that is more valuable than found among private sector corporations who compete for the same employees. Further, and this warrants special emphasis, the value of CSRS is much more than offset by the lower values of Federal salaries and non-retirement benefits. From the perspective of total compensation, the only fair approach is to introduce a new retirement system that at least preserves the value of the current system. Reducing the value of the retirement system would weaken the only financial inducement that Federal employment can offer to attract and retain the people needed to do the important work of this government.

One important result of the Ford/Oakar proposal will be to avoid any radical long-term shifts in the workforce as a result of new retirement concepts. CSRS has evolved over half a century to meet the needs of a career workforce. It provides full benefits to long career employees, encouraging experienced staff to stay the full route and provide the government with a solid base of knowledge and continuity.

There will inevitably be some shifts in Federal career patterns under any new retirement system. The greater portability of benefits under social security and the capital accumulation plan (CAP) must be paid for by some reductions in the guaranteed level of benefits for career employees. But the Ford/Oakar proposal continues to provide a strong focus on full-career benefits, and devotes its program dollars accordingly. In the absence of any demonstrated need to reshape the composition and career patterns of the Federal workforce, we see no cause to introduce a dramatic change in the philosophy, design, and benefit distributions of the retirement system.

Cost to the Government

The Congressional Research Service retirement cost model has been used extensively by both this Committee and its counterpart in the Senate. It is a sophisticated model that allows policymakers a ready and thorough picture of the effects and costs of various proposals and their components. We are, of course, delighted that the Congressional Research Service has built their model using the Hay/Huggins Pension Valuation Language. More importantly, however, we are convinced that use of a single model has effectively concentrated the debate on the important and difficult issues at hand, avoiding esoteric disputes about the validity of different models and actuarial assumptions.

The Congressional Research Service model shows that the Civil Service Retirement System costs the Federal government, and therefore the taxpayers, 25.0% of payroll. Your proposed system would cost 25.5% of payroll. While the Ford/Oakar proposal was carefully designed to replicate the current system as much as possible, the total cost is slightly higher than CSRS. This results from the need to contribute additional funds to cover the redistribution of a portion of social security contributions toward the benefits of non-Federal workers.

Our study of over 800 private sector firms showed that the CSRS is worth 6% of salary more than the total retirement system of the typical private sector firm. But this advantage in the retirement area is more than offset by higher salaries and more extensive non-retirement benefits in the average private sector firm. Further, about 10% of the private sector firms in our study provide retirement packages that are more valuable than CSRS.

Let's return to the average case, though, to view CSRS from a total compensation perspective. We estimate that, by the end of next year, the total compensation of Federal employees will have slipped 16% behind the average in the private sector. With no substantial improvements in salaries or other benefits in sight, it seems to us to be important to make every effort to preserve the full value of the one component of Federal compensation that is valuable and competitive relative to the private sector.

The two options in S.1527 would both cost the government about 22% of payroll. This cost reduction of 3.5% of payroll must come from reduced benefits under the new system. In the case of S.1527, most of the savings are achieved by limiting cost-of-living protection and scaling back early retirement benefits.

Cost to the Employees

Employees covered by social security must contribute an average of 5.9% of salary to that system. The Ford/Oakar proposal would require contributions to the retirement system of 1.3% on all salary in the first year declining to .8% in 1990 as social security contributions increase. Finally, you would permit the employee to contribute up to 10% of salary to the CAP.

Cap. Accumulation Plan
We estimate that the average contribution to the CAP will be 2.8% of salary. Combined with an average contribution to the retirement system of .9% of salary and to social security of 5.9% of salary, the typical contribution will be 9.6% of salary. This would exceed the 7% contribution to CSRS by 2.6%, on average. Most of the increase would be attributable to additional savings that the employee would be entitled to at any time on leaving Federal service.

Senate option A would not require a retirement system contribution and would also permit up to 10% to be paid to the CAP. Option B would permit the same CAP contribution and require a retirement plan contribution of 7% less the social security contribution on all salary.

An important difference between the retirement plan contribution under the Ford/Oakar approach and Senate Option B is that you would only require the difference between 7% and the social security contribution, currently 1.3%, on all salary. Option B would require the higher-paid employees to increase their retirement plan contribution to 7% when the social security contribution stops, currently at \$39,600. The Ford/Oakar proposal would permit the higher-paid employee to channel this additional amount to the CAP plan to build the funds needed to voluntarily offset the redistribution of benefits under social security.

Elements of Cost

The cost of the new system will be split among three major components: social security, the supplemental retirement system, and a capital accumulation plan. The cost of social security is fixed. The average employer/employee contribution is 5.9% of salary, taking into account scheduled changes in the social security contribution rate and the fact that contributions are not made on salaries above the maximum taxable wage base. A total of 11.8% of salary will be paid under any new system, with those contributions financing benefits according to the categories and patterns stipulated in social security.

The cost of the supplemental retirement system is calculated and expressed in terms of "normal cost". This is the percent of pay which would have to be contributed for a typical group of new employees, over their total Federal careers, to pay for all the benefits that would be earned by the entire group. The Congressional Research Service has determined that the normal cost of the supplemental retirement system in the Ford/Oakar proposal would be 19.1% of payroll. The long term allocation of this cost would be 18.2% paid by the employer, and .9% contributed by employees.

The cost of the CAP, and the level of average employee contributions, depend on the design of the system and the degree of voluntary participation over time. The Ford/Oakar proposal uses a very common private sector CAP design. It permits each employee to contribute up to 10% of salary, with a 50% employer match on the first 6% of salary. Our projection is that employees would contribute an average of just under 3% of salary to the CAP, resulting in a government matching cost of 1.4% of salary.

With these elements, the total contribution is:

| | <u>Employer</u> | <u>Employee</u> | <u>Total</u> |
|---------------------------|-----------------|-----------------|--------------|
| Retirement plan | 18.2% | 0.9% | 19.1% |
| Capital accumulation plan | 1.4% | 2.8% | 4.2% |
| Social security | 5.9% | 5.9% | 11.8% |
| Total | <u>25.5%</u> | <u>9.6%</u> | 35.1% |

Retirement Benefit

It is in the supplemental retirement system that the Committee, and the Congress, face a wide range of choices about benefit designs and the resulting costs. The structure and level of the basic retirement benefit is the foundation for all benefits from the system. The Ford/Oakar proposal uses the concept of an "add-on" formula, as do the Senate options. For each year of service, an employee receives a benefit of one percent of the average salary over the highest three years (high-three salary).

The Ford/Oakar bill provides an accrual of 1% of high-three salary for each year of service. As in CSRS, employees can receive the full earned benefit at age 55 with 30 years of service, at age 60 with 20 years of service, or at age 62 with 5 years of service. In order to pay full continuous benefits, Ford/Oakar also provides a supplement from the point of retirement to age 62, equal to the expected social security benefit.

The Senate options and the Ford/Oakar proposal would each credit about 1% of the pay base to retirement for each year of service. A typical employee with 30 years of service would receive 17% of salary from social security so the total including the 30% from the retirement system would come close to the CSRS replacement income. There are, however, important differences between your approach and the Senate approach that lead to significantly different benefits at retirement.

The Senate options base the benefit on the high-five pay base rather than the CSRS high-three approach that is preserved in your proposal. Second, Senate Option A reduces benefits by 2% a year under age 62. Finally, neither Senate option provides a supplement before age 62 to level out the benefits before and after payment of social security.

The following illustration compares the result of the Senate and Ford/Oakar proposals for a typical employee retiring at age 55 with 30 years of service:

| | |
|----------------------------------|----------|
| Salary in year before retirement | \$30,000 |
| CSRS Benefit | \$15,900 |
| Ford/Oakar proposal | |
| Retirement benefit | \$8,500 |
| Supplement | \$4,800 |
| Total | \$13,300 |

Senate Option A

| | |
|------------------------------------|---------|
| Retirement benefit = total benefit | \$6,900 |
|------------------------------------|---------|

Senate Option B

| | |
|------------------------------------|---------|
| Retirement benefit = total benefit | \$8,100 |
|------------------------------------|---------|

CSRS would provide income of \$15,900 for an employee retiring at age 55 with 30 years of service and a final salary of \$30,000. The Ford/Oakar proposal would pay a retirement benefit of \$8,500 plus a supplement of \$4,800 until age 62 when an equivalent social security benefit would begin. A CAP contribution of 3.5% of salary would add enough income to permit retirement at age 55 at CSRS levels.

The Senate options would produce annual income of \$6,900 to \$8,100. Without a supplement, it would not be possible to produce CSRS income levels at age 55 even with the maximum CAP contribution. The result would be to delay many retirements from age 55 to age 62 when full benefits would begin.

CSRS provides the same percentage benefits to all employees with the same service. Because of the design of the social security benefit formula, all of the options, including Ford/Oakar, would redistribute benefits among income categories. If, as in Ford/Oakar, the average benefit is close to that of CSRS, the lower-paid employees would receive somewhat more and the higher-paid employees somewhat less than under CSRS. We would note, however, that the higher-paid employees have more

disposable income to invest in the CAP than the lower-paid employees. The end result could be the same as under CSRS, at the option of the employee.

There are several important groups under CSRS who are entitled to full retirement benefits at ages before 55 to permit the government to maintain a young effective workforce. These include law enforcement officers, firefighters, and air-traffic controllers. To build a new retirement system that is consistent with CSRS, the Ford/Oakar proposal continues the current retirement eligibility conditions for these employees and provides the higher accrual rates needed to replicate CSRS benefits. Changes in the eligibility or benefits should follow specific consideration of the workforce needs, not be achieved through arbitrary changes in categories in designing the new retirement system.

The Ford/Oakar proposal continues the practice of charging .5% more to hazardous duty employees for their share of the added benefits. By charging the balance of the added cost directly to the agencies with employees entitled to these benefits, there is no impact on the cost of the system for the general benefits.

Inflation Protection

Ford/Oakar continues the CSRS practice of providing full protection against the erosion of retirement income due to rising prices. Since 1962, a decade before the concept was introduced for social security benefits, Federal benefits have had a statutory formula providing full cost-of-living protection.

Senate Option A would remove the protection entirely until age 62, and from age 62 to age 67 would adjust benefits by 2 percent less than the actual inflation rate. Option B would provide reduced protection before age 62 and full protection from that point on.

These limitations on inflation protection could seriously erode the value of the benefits, especially in Option A. If inflation averaged 4 percent per year, an employee retiring at age 55 under Senate Option A would lose over 30% of the value of the supplemental benefit by age 67. Under the Option B formula, benefits would lose 13% of their value between ages 55 and 62.

In addition, the CAP provides no automatic protection against inflation. The retiring employee could elect to receive an indexed annuity, but would pay for it by greatly reducing the initial amount of the annuity. Without indexing, this part of the benefit would erode throughout the retirement years.

Survivor Benefits

CSRS provides valuable benefits to survivors of deceased employees. Ford/Oakar would provide benefits that emulate those of CSRS. All employees with more than 18 months of service would receive a benefit equal to 50% of the accrued retirement benefit, without any further reductions. For example, the survivor of an employee with 20 years of service at death would be entitled to a benefit of 10% of high-three salary. The average social security benefit for a surviving spouse is over 20% of salary. When the two are combined, the total benefit would usually exceed the 21% benefit typically payable under CSRS.

In addition, Ford/Oakar provides a floor of protection to survivors who are not entitled to social security. A gap in social security coverage occurs between the time the youngest child reaches age 16 and the time the widow or widower reaches age 60. During this time, your proposal would pay a benefit to survivors of typical employees equal to the benefit currently paid under CSRS. To avoid notches in the formula, the floor benefit would be limited to the benefit that would be paid at age 60 under the basic Ford/Oakar formula, plus social security.

Survivor coverage under the Senate options begins with the same 50% of the accrued benefit. Again, though, it would be based on high-five pay and, in the case of option A, not fully protected against inflation. The Senate proposals do not provide any special coverage during the social security blackout period. Instead of directly filling in benefits in the blackout period, the Senate options provide for additional coverage through basing the benefit on at least ten years of service and providing increased life insurance amounts.

Disability

The Ford/Oakar disability benefit will be 20% of high-three salary for the typical employee who is eligible for social security. When combined with an social security benefit that averages 30% of salary, the total benefit is around 50% of salary compared to the typical 40% in CSRS. As in CSRS, a drop in the benefit at retirement is avoided by limiting the benefit to the amount that would be computed on service projected to age 60.

About three-fourths of disabled Federal employees will be eligible for social security. Those not eligible will rely entirely on retirement system benefits until age 62. To provide reasonable income to these disabled employees, Ford/Oakar would pay a supplement equal to the basic benefit. In other words, the typical employee would receive 20% from the retirement system, and about 50% in total, when eligible for social security, and 40% when social security benefits were not payable. To avoid a notch at age 62, the supplemental benefit is limited to 70% of social security disability benefits, consistent with the social security reduction factor for benefits received at age 62.

The Senate options would pay 60% of high-five salary, minus the social security benefit. At age 62, the benefit would change to the accumulated retirement benefit including service and indexing to age 62. Employees not eligible for social security would receive a benefit of 40%

of pay.

Disability is the one benefit area where the Senate bill could be more liberal than the Ford/Oakar proposal. In following the CSRS design, your proposal provides lower benefits than the typical private sector plan used as the model for the Senate provisions. The Ford/Oakar approach is consistent with the overall philosophy that the new system should emulate CSRS. If there is a need for liberalization of CSRS disability benefits, that should occur after a consideration of the entire system.

Capital Accumulation Plan

Capital accumulation plans have become an important element in total retirement benefits in the private sector. Our latest survey shows that two-thirds of employers provide a CAP plan as the third leg of a retirement program that includes social security and a traditional pension system. Ford/Oakar introduces this concept to Federal retirement policy by incorporating a typical private sector CAP to complement the overall system.

The Ford/Oakar CAP allows all employees to contribute up to 10% of salary into the plan. For those covered by the new retirement plan, employing agencies will contribute an additional \$.50 for each dollar of employee contributions up to 6% of pay. Thus, a new employee will be able to build a fund of 9% of salary by contributing 6% each year. This accumulating fund will allow the individual employee flexibility in tailoring a retirement income pattern. This will be particularly important for higher paid employees whose benefits from the retirement system and social security are lower than from CSRS.

The administration of the CAP has been designed to incorporate the best features of private sector systems within the constraints necessary for a Federal plan. Employees will be given semi-annual opportunities to adjust the amounts of their contributions, to channel them to specified investment options, and to shift the investment of their total accumulated accounts. There will be six investment options, ranging from funds providing steady earnings with virtually no risk to funds trading in more speculative equity and bond portfolios. Individual employees will be free to pursue the most appropriate mixes of risk and return, and to adjust them as their circumstances and needs change over the course of their careers.

The employee could allocate his or her contribution could among any of the six investment options. For the first five years, employer matching contributions will be directed to a government securities investment fund. After five years, the employee will be able to allocate new matching funds to any of the six investment options. This will avoid any possible adverse budget consequences in the short term. In fact, a significant number of employees can be expected to invest some or all of their own contributions in the government securities fund. As a result, it is quite possible that the overall effect will be to increase net Federal revenues over the first five years.

The CAP will be a new concept to Federal employees and will have to be explained comprehensively and clearly, so that employees are equipped

to make appropriate decisions in light of individual circumstances. We find that in the private sector a CAP is often perceived by employees as one of the most valuable benefits that an employer offers. This perceived value depends very much on the extent and quality of initial and ongoing communication.

The Ford/Oakar proposal also recognizes that employees sometimes make choices that need to be changed in light of changing economic situations and individual needs. The CAP is primarily designed to supplement retirement income. However, heavy, and often unexpected, financial needs make it important to be able to have access to the funds before retirement. Ford/Oakar follows the private sector practice of permitting loans and/or withdrawals in cases of demonstrable financial hardship. The proposal also allows employees to stop contributions at any time. This will be particularly important in the first year of the program, when some employees may join the CAP in the euphoria of initial implementation and then discover they cannot actually afford a reduction in take-home pay.

When the program begins, all employees will be able to join immediately. Employees hired after commencement will have to wait until the second open season (i.e. 7 to 12 months) to join. We find that this is a reasonable qualification period to permit employees to fully appreciate the options available and to reduce the administrative burdens of establishing accounts for new entrants, many of whom will leave within the first year.

Employees will be fully and immediately vested in the matching agency contribution as well as in their own funds. This will provide a valuable incentive to join. It will also avoid complex procedures for reverting nonvested funds to the employing agency or to plan participants.

Option A of the Senate plan provides a CAP match of 100% on all employee contributions up to 5% of salary. An employee who participates by contributing 5% of salary would have an annual contribution of 10% to the CAP compared to 7.5% under the Ford/Oakar proposal. This design reflects a significant difference in approach between the two proposals. The Senate Option A would direct more funds to the CAP plan and away from the defined-benefit retirement plan. The typical private sector approach used in the Ford/Oakar proposal would assign a much less important role to the CAP plan.

Option B of the Senate plan provides a CAP that matches a graduated percent of the employee's contributions. It provides high matching rates for initial contributions, and then decreases the rate gradually as contributions approach the matchable ceiling. For fully contributing employees, the total Option B match is very close to the Ford/Oakar match.

Both Senate options would provide a gradual vesting of agency contributions, and would require investment of agency and employee contributions in government securities for an extended period after implementation. These provisions contrast with the Ford/Oakar approach of full and immediate vesting and the ability to direct all employee contributions to any of the six investment options.

Conclusion

Mr. Chairman, this Committee and its staff are approaching the conclusion of long and difficult effort. Once social security coverage was extended to Federal employees, there fell to this Committee the challenge of retooling CSRS for covered employees without needlessly abandoning its basic structure and design.

The Ford/Oakar proposal for a new Civil Service Supplemental Retirement System is a careful, responsible answer to that challenge. It provides adequate levels of guaranteed total benefits within the constraints of social security's benefit system -- not just to retirees, but to their survivors and to employees who become disabled. It protects all of these benefits from potentially substantial erosion due to rising prices. On top of these guarantees, as a prudent cost target allows, it provides employees with additional opportunities for retirement income through a capital accumulation plan in line with plans widely available in the private sector.

Mr. Chairman, I hope I have provided the Committee today with a through assessment of the major components of the Ford/Oakar and how it differs from the two proposals embodied in the pending Senate legislation. Hay/Huggins has enjoyed the opportunity to work with the Committee and its staff over the past three years. We are prepared to answer any questions the Committee may have.